247

No. 15,~~427~~

IN THE

United States Court of Appeals

For the Ninth Circuit

Louis L. Gowans and Helen T. Gowans, husband and wife,
Petitioners on Review,

vs.

Commissioner of Internal Revenue,
Respondent on Review.

BRIEF FOR LOUIS L. GOWANS AND HELEN T. GOWANS, PETITIONERS ON REVIEW.

Frank D. Padgett,
312 Castle & Cooke Building, Honolulu, Hawaii,
Attorney for Petitioners.

Robertson, Castle & Anthony,
312 Castle & Cooke Building, Honolulu, Hawaii,
Of Counsel.

FILED
JAN 25 1957
PAUL P. O'BRIEN, Clerk

Subject Index

	Page
Jurisdictional statement	1
Statement of the case	1
Questions involved	6
Specifications of error	7
Summary of argument	8
Argument	9
I. The agreement of September 4, 1945, constituted a sale of the sand in place and the petitioners thereafter retained no economic interest in the sand	9
II. Even if it should be held that an economic interest was retained in the mineral under the 1945 agreement no such interest was retained under the agreement of May 19, 1950	24
III. The agreement of September 4, 1945, having been a sale and no initial payment having been made, petitioners should be refunded taxes paid in 1948, 1949 and 1950 on account of income received from the sand	27
Conclusion	28

Table of Authorities Cited

Cases

Pages

Arthur N. Trembley v. Commissioner, 1948 T.C. Mem. Dec., P-H vol. 17, par. 48,270 ....15, 21, 23, 26

Arthur S. Barker and Alberta C. Barker, 24 T.C. 1160....9, 12, 13

Burton-Sutton Oil Company v. Commissioner, 328 U.S. 25 (1946) 14, 16

Crowell Land & Mineral Corp., 25 T.C. 223 ....9, 10, 11, 12, 13

Hamme v. Commissioner, 209 F. 2d 29 (4th Cir. 1953) ..13, 15, 20

Helvering v. Elbe Oil Land Company, 303 U.S. 372 (1938) 14, 22, 26

Lincoln D. Godshall v. Commissioner, 13 T.C. 681 (1949) 14, 16, 20, 21

Otis A. Kittle v. Commissioner, 21 T.C. 79 (1953) 17, 18, 19

West v. Commissioner, 150 F. 2d 723 (5th Cir. 1945) ..14, 17, 18, 19

Statutes

Hawaiian Organic Act (48 U.S.C. Section 668):

Section 73 24

Section 73(g) 2

Internal Revenue Code:

Section 22 6

Section 44(b) 6, 9, 27

Section 117 6

Internal Revenue Code of 1939:

Sections 272 and 1011 1

Internal Revenue Code of 1954:

Section 6213 1

Section 6214 1

Section 7442 1

Title 26 U.S.C. Sections 7482 and 7483 1

Other Authorities

Regulations 111, Section 29.44-2 27

No. 15,427

IN THE

United States Court of Appeals

For the Ninth Circuit

LOUIS L. GOWANS and HELEN T. GOWANS, husband and wife, *Petitioners on Review,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent on Review.*	

BRIEF FOR LOUIS L. GOWANS AND HELEN T. GOWANS, PETITIONERS ON REVIEW.

JURISDICTIONAL STATEMENT.

The jurisdiction of the Tax Court of the United States was based upon Title 26 U.S.C. Secs. 272 and 1101 of the 1939 Internal Revenue Code being Secs. 6213, 6214, and 7442 of the 1954 Internal Revenue Code. The jurisdiction of this court is founded upon Title 26 U.S.C. Secs. 7482 and 7483. The decision was entered July 5, 1956, and the petition for review was filed July 20, 1956. (R. pp. 68 and 69-72.)

STATEMENT OF THE CASE.

Petitioners are husband and wife, both employed, who throughout their married lives have combined their earnings, services, and capital. (R. pp. 43, 44.)

In 1944 and 1945 they were the owners of Lot 824 Mikiki Roundtop Lots Honolulu. This property was originally granted to A. V. Gear under the Homestead Laws of the Territory of Hawaii by Land Patent Grant No. 6815. (R. p. 44.) In 1938 Petitioners purchased Lot 822 of said lots by special sale agreement 1762 under the terms of which they were obligated to build a dwelling thereon. (Exhibit II.) Sec. 73 (g) of the Hawaiian Organic Act, 48 U.S.C. Sec. 668 restricts the alienation of such lot by prohibiting any deed or lease to an alien or corporation without the written consent of the Territorial Commissioner of Public Lands and the Governor of the Territory. (Exhibits I-VI.)

The two lots in question contain deposits of a volcanic material known as "black sand" valuable in the manufacture of tile products. Honolulu Construction and Draying Company, Limited hereinafter referred to as "HC&D" offered to purchase approximately 4.33 acres of the two lots to obtain the black sand and Petitioners were willing to sell at the price offered. However, when the matter was given to HC&D's attorney to draw a deed, he determined that the Petitioners had not perfected their title to Lot 822 by erecting a dwelling and that the sale required the written consent of the Commissioner of Public Lands and the Governor. Said consent was requested and refused. (R. p. 46.) (Exhibits III and IV.)

Petitioners and HC&D then hit upon the plan of selling the sand to HC&D in place, HC&D to remove the sand paying 40c per cubic yard and leaving the

area graded with road, water and pipeline improvements installed according to the requirements of the City Planning Commission of the City of Honolulu so that the land might be subdivided and sold. (R. pp. 46 and 47.) HC&D employed Roswell Towill, an engineer and surveyor, instructing him to estimate the amount of black sand available for removal under such a plan and the cost of the subdivision and to draw plans for the subdivision. He did this estimating the amount of sand available between the surface and the projected level of the subdivision at 250,000 cu. yds. (R. p. 47.) Unless the sand had been removed, no subdivision conformable to the requirements of the Planning Commission was possible. (R. p. 117.) Also necessary to the plan was the obtaining of a roadway easement across the adjoining property. This easement was negotiated by HC&D. (R. p. 127.) On September 4, 1945, Petitioners and HC&D entered into an agreement whereby it was agreed that HC&D would buy the sand area, 192,000 sq. ft., if consent from the Commissioner of Public Lands and the Governor could be obtained, and if not, HC&D would buy approximately 250,000 cu. yds. of black sand paying 40c a cu. yd. therefor. HC&D was to quarry the sand within five years, paying for it as hauled away, and leave the property graded for a subdivision and was to install the road and pipeline improvements necessary to obtain the approval of the Planning Commission for such a subdivision. (Exhibit V.)

In September 1945, preliminary approval for the subdivision was obtained from the Planning Commis-

sion. (R. p. 116.) HC&D agreed to build for Petitioners a house on Lot 822 to enable them to perfect their title thereto. The house, which was built in 1946, cost $19,322.81 and this amount was charged off against the sand as it was removed. (R. pp. 149 and 150.) The house was begun in January 1946 and on completion later that year a land patent for Lot 822 issued to Petitioners. (R. pp. 47 and 48.) (Exhibit VI.)

In May of 1948, the cost of the house was finally completely charged off against the sand removed. (R. p. 150.) In August of 1947 Petitioners had signed a note with the Bishop Bank of Honolulu promising to pay $70,000.00 in monthly installments of $1,050.00 (Exhibit IX), and in September of 1947 assigned their rights in the 1945 agreement with HC&D to the Bank as security for the note. (Exhibit VIII.) In March of 1948, HC&D commenced paying Petitioners $1,050.00 a month regardless of the amount of sand taken out. (R. p. 150.) HC&D did this because of an oral understanding which it had had with the Petitioners from the beginning that the payments over the term of the agreement would be kept level and because sand was not being removed as fast as anticipated. (R. p. 92.) HC&D was delayed until 1947 in starting to remove the sand because of the necessity for Petitioners to clear their title to Lot 822, (Exhibits X, XI), (R. p. 48), and did not therefore remove sand as fast as originally planned. (R. p. 134.) Consequently, it sought and obtained an extension of the time to remove the sand, in return for which it obligated itself to pay $2,040.00 per month during the remainder of the

extended agreement directly to the Bishop Bank rather than the Petitioners together with the interest on Petitioners' note to the bank which it guaranteed and a proportionate share of the real property taxes. (Exhibit XII) (R. p. 135).

Petitioners, because of the extension, had been compelled to make new financial arrangements to meet their commitment and this occasioned the provision for the payments directly to the Bank by HC&D (R. p. 135). In order to meet the deadline under the agreement as extended, HC&D was compelled to rent extra land and stockpile approximately 100,000 cu. yds. of black sand thereon. (R. p. 93.) HC&D finished removing sand in 1952. (R. p. 49.) Sand removed and payments therefore during the term of the agreement were as follows:

Years	Cu. Yds.	Cash Payments
1947	35,897.47	$ 14,358.98*
1948	30,694.50	$ 14,463.83*
1949	40,356.25	$ 12,600.00
1950	44,492.25	$ 19,126.57
1951	16,414.50	$ 24,480.00
1952	81,955.03	$ 13,974.62
	250,010.00	$100,004.00

*as received by Petitioners; $13,247.18 (1947); $16,575.63 (1948).

Petitioners returned their receipts from the sand as capital gains. Respondent held them to be ordinary income. (R. p. 50.) Petitioners paid for the years 1948, 1949, and 1950, respectively, as income taxes on account

of sand receipts $1,656.92, $1,657.22, and $2,827.20 for which they filed claims for refund (R. p. 52). Repondent as a result of his determination that sand receipts in 1948, 1949, and 1950 were ordinary income (R. p. 30) determined income tax deficiencies as follows:

1948	$2,784.52
1949	$2,016.86
1950	$4,759.92

Petitioners, having received the deficiency letter, took the matter to the Tax Court where, after hearing, a decision was rendered upholding the determination of the Respondent. (R. p. 68.) Petitioners then filed this petition for review here.

QUESTIONS INVOLVED.

There are two questions involved:

The first is whether the sand was a capital asset sold in place by the Petitioners in which case the gain on the receipt from said sale would be capital gains under the then Sec. 117 of the Internal Revenue Code, or whether the Petitioners retained an economic interest in the sand so that the receipts therefrom were ordinary income under the then Sec. 22 of the Internal Revenue Code.

A second question is whether if the Petitioners are correct, they erred in not returning the whole price of the sand as capital gain in 1945 pursuant to the then Sec. 44 (b) of the Internal Revenue Code.

SPECIFICATIONS OF ERROR.

1. The Tax Court erred in not holding that as a matter of law the agreement of September 4, 1945, constituted a sale of the black sand in place and that therefore Petitioners thereafter retained no economic interest in such sand.

2. The Tax Court erred in holding as a matter of law that an economic interest was retained in the sand after May 19, 1950 by Petitioners.

3. The Tax Court erred in not holding as a matter of law that since the agreement of September 4, 1945 was a sale and no initial payment was then made, Petitioners should be refunded taxes paid in 1948, 1949, and 1950 on account of income received from the sand.

4. The Tax Court erred in holding as a matter of law that Petitioners retained an economic interest in the black sand present in place on their lots in 1948, 1949, and 1950.

5. The Tax Court erred in holding as a matter of law that the receipts from black sand in 1948, 1949, and 1950 by Petitioners were taxable as ordinary income.

6. The Tax Court erred in failing to hold as a matter of law that since the Petitioners received the total amount of $48,960.00 for the black sand remaining in place on their premises on May 19, 1950 through the device of a bank loan which the Honolulu Construction and Draying Company, Limited guaranteed and obligated itself to pay at the monthly rate of $2,040.00 that they thereafter retained no economic interest in the sand.

7. The Tax Court erred in sustaining Respondent's determination of additional taxes due in 1948, 1949, and 1950.

SUMMARY OF ARGUMENT.

Petitioners sold the black sand on their property lying between the surface and certain fixed grade levels and estimated to be approximately 250,000 cu. yds. to HC&D at a price of 40c per cu. yd. HC&D was to remove this definite amount of black sand within a five-year period and to perform certain work on the premises so as to leave them in a condition permitting subdivision under the rules of the City Planning Commission of the City and County of Honolulu. HC&D was also to install required subdivision improvements. It was the oral understanding of the parties that HC&D would attempt to make the removal of the sand on an even basis so that Petitioners would receive a relatively stable amount each month during the five-year period.

There was no substantial element of uncertainty in what the Petitioners were to receive or in the amount of sand which they were selling. There was no provision for a reverter of the sand to the Petitioners in the event HC&D did not remove it. On the contrary, HC&D's obligation to remove was mandatory. The conduct of the parties with respect to the extension of time for HC&D to remove emphasizes this feature even more strongly. The agreement was in the terms of the sale and was in fact a sale of the mineral in place. In these circumstances, obviously the Petitioners retained no economic interest in the sand which had been sold.

Moreover, regardless of how the agreement of September 4, 1945 may be construed, on May 19, 1950 the

parties entered into an amended agreement whereby HC&D was granted an extension of the time for removal. Under this agreement the Petitioners obtained a loan from the Bishop Bank in the amount of $48,960.00. HC&D guaranteed this loan to the bank and obligated itself to pay directly to the bank a monthly installment of $2,040.00 during the remainder of the period for removal of the sand. Petitioners thus received on May 19, 1950, an amount equivalent to 12/13ths of the remaining purchase price of the sand. To say that in these circumstances Petitioners continued to retain an economic interest in the sand on their lots is ridiculous.

The Petitioners having made a sale of the sand in 1945, and not having received a down payment thereon, erred in returning any part of the sales price as income in 1948, 1949, and 1950. Under Sec. 44 (b) of the 1939 Internal Revenue Code they were not entitled to return the sand sales price on an installment basis and therefore they should be refunded the amounts paid in those years.

ARGUMENT.

I. THE AGREEMENT OF SEPTEMBER 4, 1945, CONSTITUTED A SALE OF THE SAND IN PLACE AND THE PETITIONERS THEREAFTER RETAINED NO ECONOMIC INTEREST IN THE SAND.

The court below in its opinion relied upon the recent case of *Crowell Land & Mineral Corp.* 25 T. C. 223 on the ground that the facts were indistinguishable. The court below also cited *Arthur S. Barker and Alberta C. Barker* 24 T.C. 1160. In both of these cases dissents

were filed in the Tax Court and both are presently on appeal.

The *Crowell* case involved a so-called contract of sale between the taxpayer and a corporation interested in removing the sand and gravel from part of taxpayer's land. The sales agreement purported to sell all the sand and gravel under approximately 23.21 acres of the taxpayer's land at a consideration of 15c per cu. yd. All sand and gravel was to be removed within five years and any such material not removed would revert to the taxpayer. The taxpayer was to be paid $1,200.00 per year at the beginning of each year and the sand and gravel removed would be credited against this amount until it exceeded the $1,200.00 after which additional payments would be made. The Tax Court stated:

> Payment for deposits only as removed and retention (or retransfer) of title to the balance are typical indicia of the existence of an economic interest.
>
> (*Crowell Land & Mineral Corp.,* 25 T.C. 223)

The Tax Court therefore held that the payments were taxable as ordinary income.

The correctness of the *Crowell* case, as a matter of law, is open to serious question. But setting that feature aside for the moment, it is clear that the facts in our case are so different in several vital particulars that the case is clearly distinguishable.

In the first place, there was to be no reverter of the title to the minerals. HC&D had an absolute obligation to remove all of the mineral matter between the

surface and certain grade levels. This was estimated to be 250,000 cu. yds. HC&D in fact removed 250,010 cu. yds. of black sand. In the *Crowell* case the Tax Court stated:

> Not only the time of removal, but the act itself is shrouded in the mists of speculation.

In our case the act of removal is not "shrouded in the mists of speculation". It is required by the agreement within five years, and the time is five years.

In the *Crowell* case any payment over the minimum stipulated in the agreement was contingent on removal of the material. This was not true in the present case.

Petitioners' Exhibit 17 shows that prior to the removal of any sand whatsoever, HC&D constructed a house on Lot 822 at the cost of $19,322.81 for Petitioners in order to enable them to perfect their title to said lot and to get a patent. Thereafter, the sand as removed was charged against this expenditure by HC&D until such expenditure was completely exhausted in June of 1948. Prior to that time however, in August of 1947 Petitioners had obtained a loan from the Bishop Bank of $70,000.00 on which they promised to make monthly installments of $1,050.00 (Exhibit 8), in accordance with the parties' oral understanding that monthly payments would be kept even. HC&D before the exhaustion of the $19,322.81 advance by way of construction of the house, began in March of 1948 to make monthly payments of $1,050.00 to Petitioners in order to enable them to meet their commitment at the bank. Except for one or two months, this monthly payment was well

in advance of sand actually removed. This arrangement continued until in May of 1950 the amended agreement was entered into whereby the HC&D agreed with the bank to pay it $2,040.00 per month regardless of the amount removed. Thus Petitioners were regularly paid in advance of removal and under the 1950 agreement actually received, prior to removal, in a lump sum, 12/13ths of the remaining purchase price of the sand.

The agreement entered into between HC&D and Petitioners is in the terms of a sale of the sand in place.

Unlike the *Crowell* case, the obligation to remove the mineral was fixed and absolute, as is shown not only by the lack of any reverter clause in the instrument itself but by the fact that HC&D was to leave the land graded to levels determined prior to the making of the agreement. In the *Crowell* case the amount of material to be removed and paid for was uncertain. Here it was fixed by the surveyor's mathematical calculation at approximately 250,000 cu. yds. before the agreement was ever drawn. This amount was the minimum which could be removed if grade levels acceptable to the City Planning Commission were to be established. All of these features serve to distinguish this case on the facts from the *Crowell* case.

The case is also distinguishable from *Arthur S. Barker and Alberta C. Barker,* 24 T.C. 1160, also cited by the court below. That was a case in which the Petitioners contracted with a sand and gravel company to remove the sand and gravel beneath certain areas of

land owned by them paying a minimum payment regardless of the amount removed and in addition a royalty fixed at 6c per cu. yd. of commercially removable materials. As the Tax Court pointed out:

> It was agreed that Stears was not under any obligation to remove any sand and gravel.

The period of removal was fixed at fifteen (15) years with the gravel company having an option to extend the period for an additional ten (10) years but the amount to be removed was not fixed. The only purpose in the removal was the development of the sand and gravel deposits. Thus the Barker arrangement looks very much like an ordinary minerals lease, in contradistinction to the arrangement entered into in this case where HC&D was obligated to remove the sand, the removal period was extremely short, the amount to be removed was fixed, and preparing the land for subdivision was a major reason for the removal agreement.

It is clear, therefore, that both the *Crowell* and *Barker* cases are distinguishable on the facts from the present case. The test in the past cases of this nature has always been whether or not the taxpayer has retained an economic interest in the mineral in question. If he has parted with his rights and his economic interest, then the sale is taxed under the capital gains provision, whereas if he has retained an economic interest so that his receipts are in the nature of periodic payments such as rent, then it is held that they are ordinary income. *Hamme v. Commissioner,* 209 F.

2d 29 (4th Cir. 1953); *Burton-Sutton Oil Company v. Commissioner,* 328 U. S. 25 (1946); *Lincoln D. Godshall v. Commissioner,* 13 T.C. 681 (1949); *West v. Commissioner,* 150 F. 2d 723 (5th Cir. 1945); *Helvering v. Elbe Oil Land Company,* 303 U. S. 372 (1938).

The court below apparently abandoned this rule since it held in effect that gain on the sale of minerals is taxable as ordinary income in any case where the consideration is measured by the amounts removed. We contend that the court below erred in making the fact that payment was measured by the amount of material removed conclusive on whether the gain was ordinary income. No such talisman is found in the cases. In each case the court must look to the details of the transaction in an attempt to see whether or not an economic interest has been retained.

In *Helvering v. Elbe Oil Land Company,* 303 U. S. 372 (1938), the taxpayer was a California corporation which had certain properties consisting of oil and gas prospecting permits, drilling agreement, leases and equipment. After the discovery of oil the taxpayer sold its interest in those properties to Honolulu Consolidated Oil Company, which paid $350,000 upon the execution of the agreement and further installments totalling $1,650,000. In addition, it was provided that after the Honolulu Company had been reimbursed for its expenditures in the acquisition, the taxpayer was to receive monthly one-third of the net profits resulting from the operation of the properties. The agreement was worded in the form of an absolute sale. The taxpayer claimed an allowance for depletion which was

disallowed, the Supreme Court holding that the agreement constituted an outright sale of the properties.

In *Arthur N. Trembley v. Commissioner,* 1948 T.C. Mem. Dec., P-H vol. 17, par. 48,270, the court held that an agreement framed in terms of a sale by which the taxpayer transferred his interest in the sulphur located on certain tracts of land for a fixed cash payment with a provision of a "royalty" of $1.60 per long ton of sulphur produced on the land constituted a sale of the minerals in place. In so doing, the court placed reliance on the substantial nature of the fixed compensation and on the fact that there was no requirement for the development of the sulphur on the land. From these facts, it appeared that the agreement was not entered into for the purpose of exploiting the mineral.

In *Hamme v. Commissioner,* 209 F. 2d 29 (4th Cir. 1953), at the expiration of a preceding lease the taxpayer entered into an indenture by which it was provided that in consideration of $2,000.00 in cash and of "certain royalty payments" the taxpayer bargained and sold certain equipment, leases and real property. The amount of royalty payments was fixed by a simultaneous contract by which the royalties were to be based on net sales or net mint or smelter returns at the rate of 10% on minerals other than tungsten ores and at fixed percentages based on the quality of the tungsten ores which might be extracted. A minimum of $10,000 in royalties was to be paid every six months regardless of sales. The payments were cumulative so that any excess over the $10,000 in one six months'

period could be carried forward and applied to the minimum in the subsequent period. The Court of Appeals stated:

> Thus we cannot rely solely upon the words contained in the instruments or upon the acts of the parties thereunder to determine the tax consequences of this agreement. The Tax Court has quite properly applied to this problem the same test that is applied in determining whether depletion allowances may be taken by a taxpayer; for it is only where the taxpayer has retained an economic interest in properties or mineral rights thereon that depletion allowances are proper.
>
> *   *   *   *   *   *   *
>
> In 1932, the Supreme Court decisively settled the point that the retention of an oil royalty or permanent right to participate in "gross" receipts constituted an economic interest. (209 F. 2d 32, 33.)

In *Lincoln D. Godshall v. Commissioner,* 13 T. C. 681 (1949), the taxpayer and owner of mining rights contracted to let and grant possession of them to a corporation under a lease with option to purchase. The down payment was $11,000 and after payment of $139,000 rental the purchaser was to have a deed of the mining rights. The court stated:

> In our opinion petitioner and his associates clearly reserved an economic interest in the ore by their instrument of transfer. They recited a consideration of $139,000 as total "rental" payable, but, apart from the initial deposit of $11,000 none of this "rental" was a fixed liability. By subsequent provisions of the contract it was to be satisfied, if at all, by specified "royalties" on the

> ores actually mined, and if ore production should prove to be small or unprofitable, Shoshone was free to terminate the contract without further obligation than the payment of "rental" or "royalties" on such tons as it had extracted at that time. (13 T.C. 684-5.)

In *West v. Commissioner,* 150 F. 2d 723 (5th Cir. 1945), the taxpayers conveyed title to certain lands and the minerals in and under other land, excepting from the conveyance certain royalties of oil, gas and other minerals, particularly described in a supplemental contract. The agreement purported to be a transfer of a ⅝ths interest in the oil produced to the purchaser, ⅜ths thereof being retained by the taxpayer. The court held that on a review of all the factors, the transaction, despite the terminology used, more nearly resembled a lease than a sale. In so doing it reviewed the various paragraphs of the agreement one by one, pointing to the similarity between them and ordinary oil leases. It also placed heavy reliance on the fact that the predominating purpose of the agreement appeared to be the economic exploitation of the minerals.

In *Otis A. Kittle v. Commissioner,* 21 T.C. 79 (1953), the taxpayer was the owner of 1/63rd interest in mineral rights appurtenant to certain Minnesota iron ore properties. Upon the expiration of a preceding lease the owner entered into an agreement entitled an "amended lease" whereby the lessee was to pay over a 20-year period a minimum of $10,000, based upon an iron ore royalty of 50¢ per ton. The lease was

to run for 50 years. If the lessee took out less than 20,000,000 tons in the first 20 years it might take out ore up to the 20,000,000 tons thereafter without further payment of any royalty thereon and if it took out more than the 20,000,000 tons it was to pay for the excess at 50c per ton. The court held that the agreement was a lease and that the petitioner retained an economic interest in the 20,000,000 tons of ore, that it was not a sale in place of the 20,000,000 tons because the minimum payment of $10,000 was merely a provision for minimum royalties and not the sale price of the ore in place. See also *Burton-Sutton Oil Company v. Commissioner,* 328 U. S. 25 (1946).

As we have said previously, no one fact or factor is a talisman which in all cases will give the answer as to whether or not the landowner has retained an economic interest in the minerals. In the *Kittle* case and to some extent in the *West* case the factor which tipped the balance in favor of a decision that the owner had retained an economic interest in the mineral was the presence in the transfer agreements of covenants usually found in leases. This indicated to the court that the transfer actually was a lease and not a sale.

In contrast, the agreement of September 4, 1945, which is Exhibit V in this case, is worded in the terms of a sale, and many of the usual lease covenants are missing. Thus, covenants with regard to strip or waste, fencing, insurance, repair, lessor's right of entry for purposes of inspection, lessor's approval of plans for improvements, forfeiture, payment of taxes and other

charges, maintenance of the premises in a clean and sanitary condition and in obedience to rules and regulations of health and other authorities, are missing.

Under the agreement the land in toto is to be sold to the buyer if permission for such sale can be obtained, and if not, then the buyer is to remove the black sand and put in the subdivision improvements. The various obligations undertaken by the buyer under paragraphs 3, 4, 5 and 6 of the agreement are all concerned with the withdrawal of the sand and payment therefor and with the installation of the subdivision improvements. They bear little or no resemblance to lease covenants.

Of particular significance is the fact that the agreement is in the terms of seller and buyer and is in the alternative. It shows clearly that in the thinking of the parties the agreement was for a sale. They were attempting to make a sale of the land, and failing permission for that, to make a sale of the sand in place. As Mr. Gowans stated, this alternative amounted, from petitioners' point of view, to a sale of the land in two steps. He stated:

> It amounted to a 2-part sale, the land and the sand. If Mr. Bush could not buy the whole thing, the sand developed in the creating of the subdivision would be sold to Mr. Bush, and then I could sell the land any way I saw fit. (Tr. p. 68.)

It is thus apparent that the factor relied on in the *Kittle* and *West* cases to indicate a lease rather than a sale, in this case tips the balance the other way and indicates a sale rather than a lease.

In the *Hamme* case, *supra,* the owner's payment was to be a percentage of the gross receipts from the sale of the ore produced. The court in that case held that the fact that the owner was to be paid a percentage of gross receipts of itself indicated the retention of an economic interest. In the agreement of September 4, 1945, however, the price per cubic yard was the flat fixed sum of 40¢. Thus the factor relied on in the *Hamme* case to produce the conclusion that an economic interest had been retained is missing in our case.

In the *Godshall* case, *supra,* in deciding that there had been the retention of an economic interest the court placed its reliance upon the fact that by far the greater share of payments going to the owner was contingent upon oil or gas being produced on the land and that if there was no such production the agreement might be cancelled by the lessee. In our case, however, while payment is to be measured by production, there is no contingency in the matter of production. As the testimony shows, the sand had been measured prior to the agreement's being entered into with almost incredible accuracy and production was required by the terms of the agreement. The sand was known to be there and the agreement required its removal.

Moreover, the parties had an oral understanding that production would be kept at an even pace so as to balance out the payments over the term of the agreement. As a result, when production was not so maintained HC&D went ahead and made payments anyway, far in advance of actual production. Thus the

factor which tipped the balance in the *Godshall* case is missing in our case.

In the *Trembley* case a factor on which much reliance was placed in reaching the conclusion that there had been a sale of the minerals in place was the fact that no production was required. In our case, on the other hand, production is required but the situation is very different from that pertaining in the usual minerals agreement. In such an agreement the reason for requiring production is to secure the exploitation and development of the mineral so that the owner may be paid, and this is held to indicate the retention of an economic interest. In this connection, the court in that case quoted its statement in an earlier case that:

> *In our opinion the predominating purpose of the present contract was to secure the exploitation and development of the properties for oil,* gas and other minerals, a fact clearly evidenced by the care the petitioners used in drafting the duties, obligations, and covenants imposed on and accepted by Humble. (Emphasis supplied)
> (17 TC Mem. Dec. P-H par. 48,270, p. 864)

Of course, in our case, while the length of time within which removal was to be made was influenced by HC&D's original purpose to remove on a pay-as-you-go basis and was the subject of bargaining between the parties (Tr. p. 69), it is obvious that the predominating purpose in requiring removal of the minerals was to permit the development of the land. The owners were anxious to sell the land but were unable to do so with it in its natural state. Removal of the sand was a legal and a practical necessity before

the land could be subdivided and sold. (Tr. pp. 50, 53, 75.) As the agreement shows, if permission could have been obtained to sell the land to HC&D the petitioners would have done so. Failing that, they still wanted to sell the land and the alternative proposal was the means by which they were enabled to do so. Removal of the sand was a prerequisite to their carrying out this 2-step sale. Thus the requirement of removal of the sand does not in this case indicate the retention of an economic interest.

The factor which tipped the balance in the *Elbe Oil Land* case, *supra,* in favor of a construction that there had been a sale appears to have been the fact that a very substantial initial payment was made by the purchaser. Such a payment is missing with respect to the agreement of September 4, 1945, but on the other hand, the factor of contingency present in that case as to the additional payments is not present here. The sand was known to be there and the amount was capable of very accurate estimation. Moreover, the price was fixed and not dependent on the profits or sales of HC&D. HC&D was required to remove the black sand from the surface down to certain grade levels, taking out 250,000 cubic yards within a 5-year period and paying therefor 40¢ per cubic yard. In practice HC&D was permitted to take sand below the grade level where it was of usable quality and to fill in the resulting holes with non-usable material above the level. The amount of sand actually taken, however, was 250,010 cubic yards as against the beginning estimate of 250,000 cubic yards. A consideration of surrounding

circumstances in our case shows clearly that there was no factor of contingency in the production and this would seem to outweigh by far the lack of an initial payment.

The court below appears to have been somewhat influenced by the fact that HC&D in many of its letters and on its books referred to the payments as royalties and the fact that they were so referred to in the agreement of May 19, 1950 indicates a lease rather than a sale. However, the same use of the word "royalty" was present in the *Trembley* case and was held not to be decisive just as the use of the terminology of a sale in the agreement is not of determining significance.

HC&D's actions cannot change the nature of the transaction nor bind the petitioners, who had no control over HC&D's bookkeeping methods. It is at best an indication of intention and is certainly counterbalanced by the statement of HC&D's president that it was his intention to purchase the sand in the beginning. (R. p. 95.) If intention is to be the determining factor then the fact that both parties to the agreement testify that they intended it to be a sale of the sand, together with the use of sale terminology in the agreement, should weigh heavily in petitioner's favor.

Moreover, we call attention to the fact that when the agreement of May 19, 1950 was signed, HC&D set up on its books the total amount remaining to be paid under that agreement as a liability on the debit side of its ledger. (R. pp. 148, 149.) Thus, from that time on

the land could be subdivided and sold. (Tr. pp. 50, 53, 75.) As the agreement shows, if permission could have been obtained to sell the land to HC&D the petitioners would have done so. Failing that, they still wanted to sell the land and the alternative proposal was the means by which they were enabled to do so. Removal of the sand was a prerequisite to their carrying out this 2-step sale. Thus the requirement of removal of the sand does not in this case indicate the retention of an economic interest.

The factor which tipped the balance in the *Elbe Oil Land* case, *supra,* in favor of a construction that there had been a sale appears to have been the fact that a very substantial initial payment was made by the purchaser. Such a payment is missing with respect to the agreement of September 4, 1945, but on the other hand, the factor of contingency present in that case as to the additional payments is not present here. The sand was known to be there and the amount was capable of very accurate estimation. Moreover, the price was fixed and not dependent on the profits or sales of HC&D. HC&D was required to remove the black sand from the surface down to certain grade levels, taking out 250,000 cubic yards within a 5-year period and paying therefor 40¢ per cubic yard. In practice HC&D was permitted to take sand below the grade level where it was of usable quality and to fill in the resulting holes with non-usable material above the level. The amount of sand actually taken, however, was 250,010 cubic yards as against the beginning estimate of 250,000 cubic yards. A consideration of surrounding

circumstances in our case shows clearly that there was no factor of contingency in the production and this would seem to outweigh by far the lack of an initial payment.

The court below appears to have been somewhat influenced by the fact that HC&D in many of its letters and on its books referred to the payments as royalties and the fact that they were so referred to in the agreement of May 19, 1950 indicates a lease rather than a sale. However, the same use of the word "royalty" was present in the *Trembley* case and was held not to be decisive just as the use of the terminology of a sale in the agreement is not of determining significance.

HC&D's actions cannot change the nature of the transaction nor bind the petitioners, who had no control over HC&D's bookkeeping methods. It is at best an indication of intention and is certainly counterbalanced by the statement of HC&D's president that it was his intention to purchase the sand in the beginning. (R. p. 95.) If intention is to be the determining factor then the fact that both parties to the agreement testify that they intended it to be a sale of the sand, together with the use of sale terminology in the agreement, should weigh heavily in petitioner's favor.

Moreover, we call attention to the fact that when the agreement of May 19, 1950 was signed, HC&D set up on its books the total amount remaining to be paid under that agreement as a liability on the debit side of its ledger. (R. pp. 148, 149.) Thus, from that time on

at least, HC&D's own bookkeeping acknowledged the existence of an absolute liability under the agreement.

Considering the agreement as a whole, in the light of the surrounding circumstances it would appear that it was in fact an agreement for the sale of the sand in place. Every factor relied on in the cases weighs in favor of that conclusion in this case.

Even more indicative of a sale than these factors are the surrounding circumstances. Petitioners' land lies on a steep sloping mountainside. They desired to sell a portion of it. They could not sell it to HC&D because of restrictions on their title. They could not subdivide it and sell it as house lots because of the requirements of the City Planning Commission. So they sold the sand above certain grade levels to HC&D, requiring its removal and exacting as consideration 40¢ per cubic yard and certain subdivision improvements. Then they were in a position to sell the land. The transaction with HC&D was quite literally a sale of a slice out of the side of the mountain. To term it a lease is to ignore the legal prohibition against such leases, Section 73, Hawaiian Organic Act, 48 U.S.C. Section 668, and the facts as to what was sought to be done and actually done.

II. EVEN IF IT SHOULD BE HELD THAT AN ECONOMIC INTEREST WAS RETAINED IN THE MINERAL UNDER THE 1945 AGREEMENT NO SUCH INTEREST WAS RETAINED UNDER THE AGREEMENT OF MAY 19, 1950.

On May 19, 1950 petitioners and HC&D entered into an amended agreement whereby the time for removal

of the black sand and the installation of subdivision improvements was extended for one year and HC&D bound itself to pay to the Bishop Bank $2,040.00 per month on the principal of petitioners' note with the bank of even date in the amount of $48,960.00. HC&D also agreed to pay the interest on the note and a pro rata share of the real property taxes. (Ex. XII.) As the agreement shows, the petitioners were to get the $48,960.00 by a loan from the bank and then HC&D was to pay back this loan to the bank at fixed monthly sums regardless of the amount of sand taken out. After the bank was paid back then any additional payments on account of sand removed coming due were to be paid to petitioners. This agreement was in fact carried out.

It is difficult to see how it can logically be argued that any economic interest was retained by the petitioners after the agreement of May 19, 1950, regardless what the ruling may be with respect to the agreement of September 4, 1945. As the new agreement shows, of the approximately 133,000 cubic yards of black sand remaining to be removed at that time, petitioners by the device of the loan from the bank, which would be repaid by HC&D, received $48,960.00 or the equivalent of payment for 122,400 cubic yards of sand immediately. HC&D obligated itself to pay that amount at fixed monthly payments regardless of the amount of sand removed in the period. Previous to this time, as the testimony shows, HC&D had removed sand only as it had market for it. Now, however, in order to meet the established deadline it was forced to remove the

sand and stockpile it and it actually stockpiled some 100,000 cubic yards.

Surely it cannot be said that petitioners had retained an economic interest in the sand when they in fact had already been paid for some 12/13ths of it and when HC&D was required to remove and pay for the other 1/13th within a little over two years. If an agreement whereby an owner is paid in advance a fixed amount constituting over 92% of the total consideration for minerals in place regardless of the amount which may be removed does not constitute a sale of those minerals in place, then it is not possible to have a sale of the minerals in place. In both the *Elbe Oil Land* case, *supra,* and the *Trembley* case, *supra,* it was the factor of a large fixed initial payment, regardless of production, which seemed to be uppermost in the court's mind in ruling that there had been a sale and that no economic interest was retained. Certainly our case is stronger than either of the other two, for the percentage of the total consideration paid in advance is much greater. Unlike the *Trembley* case, of course, the removal of the minerals was required within a fixed period, but, as we have pointed out earlier, the predominating reason for that, even under the 1945 agreement, was so that the petitioners might be in a position to subdivide and sell the land. Since the agreement of May 19, 1950 did not link together payment and removal of the sand, the only economic reason remaining for requiring the removal of the sand was petitioners' desire to have the land placed in a condition where it could be subdivided and sold.

Clearly, therefore, the requirement of removal does not indicate a retention of an economic interest in the sand, but indicates quite the contrary. Petitioners, having sold the sand and having been paid therefor, wanted it removed from the land so that they could make use of the land. We submit that regardless of what construction is placed upon the earlier agreement, all payments after May 19, 1950 were properly returned as payments from the sale of a capital asset rather than ordinary income.

III. THE AGREEMENT OF SEPTEMBER 4, 1945 HAVING BEEN A SALE AND NO INITIAL PAYMENT HAVING BEEN MADE, PETITIONERS SHOULD BE REFUNDED TAXES PAID IN 1948, 1949 AND 1950 ON ACCOUNT OF INCOME RECEIVED FROM THE SAND.

Petitioners mistakenly returned all payments received on account of the sand in the years 1948, 1949 and 1950 as payments on account of the sale of a capital asset in those years. They thus treated the agreement of September 4, 1945 as an installment sale of real property involving deferred payments. (Sec. 44 (b) I.R.C.) However, under Regulations 111, Section 29.44-2, in effect at the time that the agreement and the returns were made, petitioners should have returned the whole amount to be received on account of the sand sales price in 1945, since no initial payment was made by the purchaser at that time. The payments thus made by them in the years in question were erroneous.

Even if it be argued that there was no sale in 1945 because petitioners did not get their title to Lot 822 until May of 1946 (Ex. VI), although they had title to Lot 824 previously and the sand was located on both, certainly the sale took place when they did get title in 1946, and since no payments were made on account of sand until 1947 (R. p. 49) the same argument applies with equal force. This being so, petitioners are entitled to a refund of the amounts paid in 1948, 1949 and 1950 on account of receipts from sand, to-wit, $1,656.92, $1,657.22 and $2,827.70.

CONCLUSION.

For the reasons stated above the judgment of the Tax Court should be reversed, and an order entered giving judgment in favor of the petitioners as prayed in their petition before the Tax Court.

Dated, Honolulu, Hawaii,
January 8, 1957.

Respectfully submitted,

Frank D. Padgett,
Attorney for Petitioners.

Robertson, Castle & Anthony,
Of Counsel.